

City of San Diego
Office of the Auditor and Comptroller
Memorandum

Date: April 20, 2007

To: Honorable City Council Members

From: Greg Levin, CPA Deputy Comptroller

Subject: Yellow Book Report

This memorandum is provided in response to Councilmember Frye's April 19, 2007 memorandum regarding the KPMG report on internal controls. This response ensures the City Council and the public are fully informed of the facts surrounding the release of the KPMG Yellow Book Report, related documents and the City Council's impending receipt of the audited Comprehensive Annual Financial Report ("CAFR") for the fiscal year ended June 30, 2003. Additionally, this response is necessary after the public release of an incomplete financial disclosure document.

After the release of the City's 2003 CAFR, Councilmember Frye made several requests to the Auditor & Comptroller's office regarding the KPMG Yellow Book Report. As stated in her memorandum, Ms. Frye's office made her initial request prior to the March 19, 2007 Audit Committee meeting, at which time the release of the City's Audit Opinion was discussed. A timeline of significant events surrounding this matter has been attached for the City Council's review.

Councilmember Frye's memorandum also detailed her belief that the Council would not receive this report prior to consideration of the 2003 CAFR on April 23, 2007. Additionally, Councilmember Frye requested that the council delay consideration of the City's 2003 CAFR until such time the legislative body has had an opportunity to have a public hearing and discussion regarding the KPMG Yellow Book Report. In an attachment I have also provided a response to significant points made by Councilmember Frye in her memorandum.

In closing, please be advised that the future release of such materials prior to the completion of a proper and thorough review process is fraught with risk and potential liability. Beyond non-compliance with the City's municipal code, the premature release of this document to the public could have resulted in a material misrepresentation regarding the City's financial condition and its internal controls. The fact that negative consequences were not realized in this case is a matter of luck and is the very reason why the City employs professional staff capable of understanding and providing context to our elected leaders and the public.

CC:

- Honorable Mayor Jerry Sanders
- Honorable City Attorney Michael J. Aguirre
- Ronne Froman, COO
- Jay M. Goldstone, CFO
- Andrea Tevlin, IBA
- Stanley Keller, Independent Consultant

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A discussion of Critical Points made by Councilmember Frye

In her memorandum Councilmember Frye wrote:

“I requested that KPMG provide me with copy of the March 12 report referenced in their opinion letter. I was told it was not yet completed. I requested that they provide it to me and other Councilmembers after its completion.”

A review of the attached timeline shows that Councilmember Frye was actually in receipt of the Yellow Book Report prior to completion. This was provided to her as a courtesy because she took a strong personal interest in the subject and made repeated requests. It is worth noting that the members of the Audit Committee had not received this report even though it would normally be under the purview of that Council Committee. In that regard Councilmember Frye received the benefit of my confidence and trust only to later violate that confidence.

Under the typical process, a Yellow Book Report is typically not deemed complete and presentable by the independent auditor until such time that they receive management's responses, or a communication indicating that management will not respond. This is to ensure that the auditor has correctly interpreted the matters being discussed.

Specifically, Governmental Auditing Standard 5.26 states the following:

If the auditors' report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions.

Accordingly, Councilmember Frye was in receipt of the report prior to completion and prior to concurrence by KPMG that the views of responsible officials were acceptable.

This document was released to the public prior to KPMG's concurrence with management's response, without KPMG's signature and on blank paper as opposed to KPMG's letterhead. Through the process of deduction, it appears that Councilmember Frye's office publicly released this incomplete report or provided it to the party that released it to the public because only the Chief Financial Officer, the Councilmember's staff and I had possession of the report version that was released. Discussions with Chief Financial Officer indicate that he did not provide this report to the public prior to release to the City Council. Additionally, this version of the document had not been provided to KPMG until after the public release of the document.

“it is my belief that had I not requested this report, it would not have been provided to the City Council until after we were asked to “receive and file” the 2003 CAFR.”

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I had previously provided assurances to the Chairman of the Audit Committee's staff regarding the release of the Yellow Book Report prior to the City Council's consideration of the CAFR. As of 11:00 am April 19, 2007, the City has received the final report and this document was planned for release today to assist the Councilmember's in preparation for their consideration of the CAFR. Accordingly, I have attached the finalized report along with a separate Statement of Auditing Standard 61 letter from KPMG to this document.

"I further believe that before this Council is asked to take any action on the 2003 CAFR that there be a public hearing and discussion about KPMG's internal controls report."

While it is the prerogative of the Council to consider the Yellow Book Report prior to receiving the 2003 CAFR, it is unclear to me whether the City would benefit from this action. Accordingly, I believe it is important for the City Council to consider other facts.

With the issuance of the Auditor's Opinion, the result of any changes requested by the Council as a result of their consideration of the Yellow Book Report would be to have KPMG rescind their initial opinion, reopen field work and renew the audit process. This would result in further delay in the City's reentry to public markets by delaying the release of the 2004 CAFR and subsequent CAFR's. Furthermore, the City has fully expended all available appropriations for the KPMG audit, thus the reopening of fieldwork would require an appropriations amendment resulting in a minimum two week delay in the reopening of fieldwork.

I also note that while this is the first official expression of KPMG's views on the City's internal control framework, compliance with applicable law, grants, contracts and other matters the majority of the comments contained in the Yellow Book Report - if not all of them - have previously been discussed in open meetings of the City Council. This occurred via the presentation of the City's Annual Reports on Internal Controls, the Report of the Audit Committee of the City of San Diego ("Kroll Report") and previous presentations of the City's CAFR to Council. Accordingly, the public has had numerous opportunities to hear discussion of the comments contained in the report.

The Yellow Book Report is the result of procedures performed pursuant to **generally accepted governmental auditing standards** ("GAGAS") which are for use by auditor's of government entities that receive government awards (state and federal grants). In this regard, the Yellow Book Report is performed because laws, regulations, contracts, grant agreements and other policies frequently require that audits be performed in accordance with GAGAS. Performance of a Financial Statement Audit in accordance with GAGAS is not required to render an opinion as to the reasonableness of the City's Comprehensive Annual Financial Report. Moreover, the Yellow Book Report is not a required component of a CAFR and is more typically associated with the "Single Audit Report"

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which is performed pursuant to the White House Office of Management and Budget Circular A-133.

While the firm of Macias, Gini and O'Connell is performing the City's Single Audit, GAGAS are typically applied in conjunction with other auditing standards which govern attestation engagements for governmental entities (See AICPA standards) which is the reason why KPMG is providing the Yellow Book Report. Though applied simultaneously, in the event of inconsistencies between GAGAS and standards promulgated by another standard setting body, the auditor should use GAGAS as the prevailing standard for conducting the engagement and issuing the **Yellow Book Report** and not rendering an opinion on the reasonableness of the City's financial statements. The reason for the application of GAGAS in conjunction with other procedures is stated in GAGAS paragraph 1.15(a) as follows:

“GAGAS describe ethical principles, and establish independence and other general standards, and additional field work and reporting standards beyond those provided by the AICPA for performing financial audits and attestation engagements.”

Specifically, GAGAS require that the auditor report on the scope of the auditor's testing of compliance and internal control over financial reporting and presentation of the results of those tests.

“The fact that the City Treasurer was not in attendance at final DPWG meeting where the 2003 CAFR was reviewed concerns me.”

Councilmember Frye's assertion regarding the absence of the City Treasurer at the final review meeting is correct and has been disclosed in the certification of the DPWG. I do not know the reason for the City Treasurer's absence at this meeting and defer to the Treasurer for explanation. However, this document was reviewed at prior DPWG meetings where the City Treasurer was in attendance and at that time she did vote to approve previous draft iterations. Furthermore, during the compilation process the City Treasurer's office was routinely involved in a collaborative production of the report as it pertains to her responsibilities. Specifically, the City Treasurer's office was asked to review the Letter of Transmittal, Summary of Significant Accounting Policies footnote and the Cash and Investments footnote and other associated schedules. Comments received from the City Treasurer's office were documented via email as part of the compilation process. In addition to reviewing the document on several occasions and participating in the compilation of the CAFR, the City Treasurer has been an ongoing and active participant in the City's efforts to remediate control weaknesses in the City's Cash and Investments Control Cycle.

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Timeline of Events surrounding the release of the Yellow Book Report

March 12, 2007:	KPMG concluded fieldwork on the City's 2003 CAFR.
March 13, 2007:	Auditor & Comptroller Staff presented the CAFR to the Disclosure Working Practices Group ("DPWG"), at which time a quorum was present and DPWG certified the CAFR.
March 16, 2007:	Auditor & Comptroller Staff received KPMG's audit opinion based on AICPA auditing standards. This fact was publicly disclosed immediately following receipt of the opinion.
March 19, 2007:	KPMG and Auditor & Comptroller Staff presented the opinion letter and the CAFR to the City Council's Audit Committee.
March 22, 2007:	Auditor & Comptroller Staff received the KPMG Yellow Book Report.
April 2, 2007:	Auditor & Comptroller Staff reviewed Report, provided preliminary responses and recommended edits to KPMG, Responsible Departments and Chief Financial Officer for review.
April 11, 2007:	Auditor & Comptroller Staff received responses from SDCERS management concerning findings related to SDCERS compliance with the Internal Revenue Code.
April 18, 2007:	Auditor & Comptroller Staff received responses from Metropolitan Wastewater Department management concerning findings related to Violations of the law regarding Wastewater user rates. Auditor & Comptroller Staff revised management responses and forwarded final comments and responses to KPMG. Upon request of the Council Member, a courtesy copy of the final draft submitted to KPMG by Auditor & Comptroller staff was provided to Councilmember Frye's office.
April 19, 2007:	The draft, unsigned report was posted on the independent news media website www.voiceofsandiego.org prior to staff's receipt of the final signed report. Auditor & Comptroller Staff received final, signed Yellow Book Report from KPMG approximately 2 hours after it was posted in the media.